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Financial Management and Budget
Internal Control Review

INTERNAL CONTROL REVIEW: FISHERIES OBLIGATION GUARANTEE PROGRAM; LOAN SERVICING

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SUMMARY OF REVISIONS:

Signed ________________________________
[Approving Authority name] Date
[Approving Authority title]

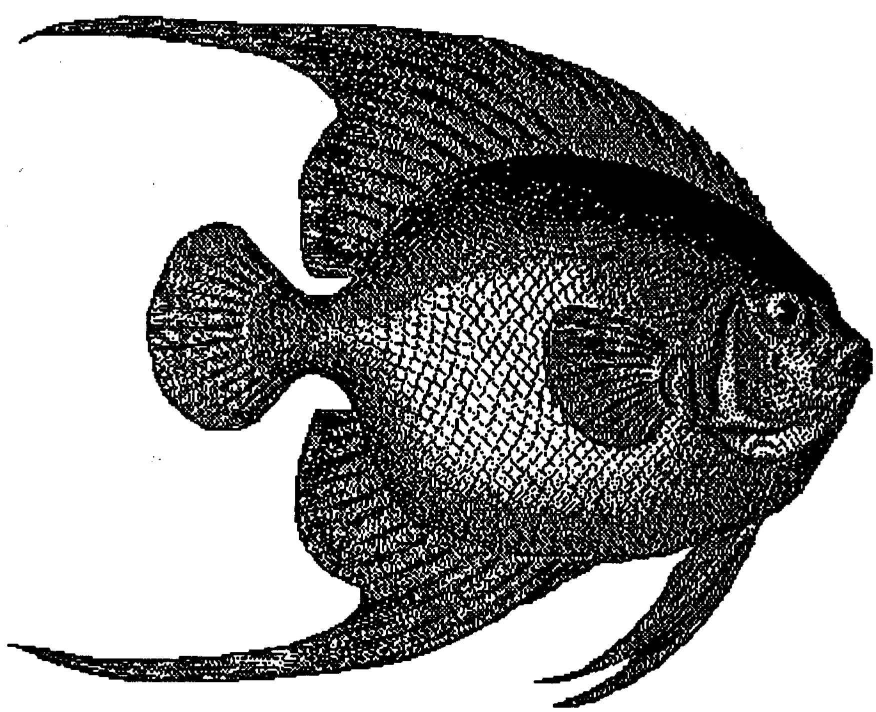
Fisheries Obligation Guarantee Program

Loan Servicing

U. S. Department of Commerce
National Oceanic and Atmospheric Administration
National Marine Fisheries Service

INTERNAL CONTROL REVIEW

July 1993



EXECUTIVE SUMMARY

FISHERIES OBLIGATION GUARANTEE (FOG) PROGRAM
LOAN SERVICING

1. INTRODUCTION

The Fisheries Obligation Guarantee Program (the "Program") provides a Federal guarantee of private debt for fishing vessels, shoreside and aquacultural facilities. The Program has guaranteed 1250 financings for $609 million since 1972. Active loan guarantees peaked at $371 million in 1990.

The Program was authorized by Title XI of the Merchant Marine Act of 1936 as amended (46 U.S.C. 1271, et. seq.). Its governing rules appear at 50 C.F.R. Part 255. The Department of Commerce "Credit and Debt Management Operating Standards and Procedures Handbook" also prescribes certain requirements for such loan guarantees.

The Program assists fishermen in obtaining long term capital in the private market. Obtaining capital is difficult for the fishing industry because it is capital intensive, high risk, subject to cash flow fluctuations, and mostly comprised of small firms. Guaranteed financings can involve maturities of between 15 and 20 years, which are longer than those available in the private market, and at rates that are lower than in the private market. This contributes to the stability of the fishing industry by stretching debt service over a longer term matching the economically useful life of fisheries processing equipment and by lowering the debt service. Accordingly, the financial pressures that complicate fishing operations for a portion of the fishing industry can be reduced, and changing fisheries management and conservation standards can be more easily accommodated.

The Program assists owners who meet its underwriting standards to obtain long term financing of up to 80% of the cost of these assets for up to 25 years. The Program extends a 100% full faith and credit Federal guarantee of successful applicants' notes. These guaranteed notes are then sold in the private market for long term capital in order to generate financing proceeds.

The National Marine Fisheries Service (NMFS) administers the

Program, through the Financial Services Division (FSD) of the Office of Trade and Industry Services. The FSD, located in Silver Spring, MD, establishes regulations and Program guidelines, approves loan guarantees, and generally supervises the Program. The three Branches in the NMFS Regional Offices (Gloucester, MA, St. Petersburg, FL, and Seattle, WA) take their direction from the FSD. They receive and review loan guarantee applications, recommend applications for FSD approval, and service active guarantees.

All credit work is done, and all credit decisions are made, by the Program. All collateral is held and serviced by the Program. Guaranteed note holders simply buy the functional equivalent of a U.S. Treasury security. Guaranteed note holders are entitled to the Program's full liquidation of the guaranteed notes if any installment payment is ever more than 30 days past due.

Until implementation of the Federal Credit Reform Act (FCRA) of 1990, the Program was self-supporting. and had no appropriated budget. The Program's user income paid the Program's administrative expenses and capitalized its reserve fund. Other than small one-time application and commitment fees, the Program's income was limited to a guarantee fee of 1% per year of the average principal balance of guaranteed notes outstanding. Since 1992, however, FCRA requires that the Program's administrative costs be funded through appropriations plus an appropriated reserve against projected future losses, despite the fact that Program users still must pay the fees described above. The Program has 30 full time permanent employees and $1.7 million of administrative costs.

The Program commits the Government to guarantee millions of dollars of financings each year. To minimize the risk to the Government, these guarantees should be made only to authorized recipients, within established monetary limits and the specified terms of the agreement. Previous ICR's have dealt with Loan Origination (1986) and Loan Closing (1989). The FOG Program was also the subject of an audit by the Office of the Inspector General (OIG) of the Department of Commerce (September, 1992).

II. SCOPE OF THE REVIEW

Selection of an ICR Team

An ICR Team, consisting of representatives of the Policy and Coordination Office and the Financial Services Division, was selected to conduct the ICR. (See Appendix B.)

Identification of Event Cycles and Selection of ICR Focus

The ICR Team analyzed the general control environment of the Fisheries Obligation Guarantee Program, and its component event cycles which are: loan origination; loan closing; care and preservation of collateral; program administration; and loan servicing. (See Appendix A.)

Serious risks are associated with loan closing and loan origination which involve the commitment of large dollar amounts in guaranteed financings and the security of collateral worth millions of dollars; however, these event cycles have already been the subjects of previous ICR's, and recommendations for improving those internal controls have been implemented. Care and preservation of collateral is primarily conducted by attorneys outside the FSD. Program administration is an ancillary staff function. Therefore none of these event cycles were chosen for review.

Loan servicing is a difficult event cycle to define because it is not a single process or type of work, and varies for each loan guarantee. It includes "normal servicing actions" (such as analysis of the borrower's financial condition and compliance with mortgage provisions, program documentation, and collection of fees and receivables), "extraordinary servicing actions" when a problem or special situation occurs, as well as "insurance and credit servicing actions." Accordingly, loan servicing may overlap the controls in other event cycles such as loan origination (i.e. refinancings) or loan closing (i.e. foreclosures).

The OIG audit of the FOG program concluded that "the program has been financially well managed"; however, it recommended that certain improvements be made to loan servicing and to other management practices. The OIG also commented that the Program in some instances failed to comply with aspects of the Department of Commerce's "Credit and Debt Management Operating Standards and Procedures Handbook."

The loan servicing event cycle was chosen for review because of higher level management concerns, some of which were identified in the OIG audit. In response to that audit, NOAA agreed to conduct an ICR of Loan Servicing in FY 1993 which adressed each of these concerns. In addition, the ICR Team decided to examine the DOC

Handbook to determine which controls may apply to NMFS, and if NMFS is or should be in compliance with them.

III. METHODOLOGY

Detailed Planning of the ICR

A detailed plan for completing the ICR was prepared and approved by the Assessable Unit (AU) Manager. (See Appendix C.)

Documentation

The ICR Team reviewed written material describing the Program, including: enabling legislation; organization charts; current budgets; planning and policy documents; GAO, OIG, and ICR reports; operating policies and procedures such as the FSD Flash Code and the DOC Handbook; computer database documentation for the Program; and management reports such as the decision records for Regional and Headquarters servicing actions. (See Appendix D.) Because this documentation was unusually extensive and complete, it was very useful in identifying and classifying important control techniques.

The ICR Team documented the controls associated with loan servicing actions (normal, extraordinary, and insurance and credit) in a narrative (See Appendix E) and flow charts (See Appendix F). These represent in words and symbols the sequence of work that is done. Their accuracy was confirmed by interviews with Headquarters and Regional staff who are responsible for daily operations.

Analysis of the General Control Environment

The ICR Team analyzed the general control environment of the loan servicing event cycle, with particular attention to the OIG audit and the DOC Handbook. (See Appendix G.) Servicing authority was centralized in Headquarters in October, 1991 (see Flash Code #366), so that many previous management controls no longer apply and new controls were instituted. The Program's organization structure, personnel, and chain of command are clearly defined and in writing. Policies and procedures are very specific and are kept current by memorandum and electronic mail. Planning and budgeting are conducted jointly with other offices.

The FOG Program Portfolio Database System (PDS) is expected to become the basis for tracking all Regional servicing activities. This automated loan monitoring system was installed in each Regional Office in late 1989. It has been completely implemented in one Regional Office, is nearly implemented in another, and is in progress in the third.

The PDS is a valuable credit management tool at both the Branch and Division level. The PDS: records the analysis of the portfolio's financial condition, its collateral position, and its servicing history; requires a risk rating of each portfolio account, which the Branches use to establish watch lists; accounts for financial statement and collateral survey reporting requirements; documents collection activity for delinquent guarantee fees, advances, or other receivables; helps ensure that all other suspended actions are appropriately accomplished; documents account problems of every sort and the servicing response to them; provides due diligence documentation for refinancings, payment deferrals, collateral releases, covenant waivers, and all other portfolio servicing actions; allows managers to monitor the performance of credit officers; and provides a ready synthesis of each portfolio account's servicing status.

<u>Determination of Risks</u>

The ICR Team identified seven risks, or negative events which could occur if the Program was not administered as planned. (See Appendix H.)

RISK 1. The Government may suffer catastrophic, uninsured loss.

RISK 2. The Government may accept unnecessary financial risk.

RISK 3. The Government may fail to meet its legal financial responsibilities or vendors may be overpaid.

RISK 4. An illegal or unauthorized servicing action may be taken.

RISK 5. A loan may unnecessarily default or a bad loan may be strung out to avoid default.

RISK 6. Collateral documents may be lost or stolen.

RISK 7. The Inspector General's findings in the Program audit may not be addressed.

Determination of Control Objectives

The ICR Team assigned to each of these risks a corresponding and opposite control objective, a condition which the AU Manager wants to occur. (See Appendix H.)

Determination of Existing Control Techniques

The ICR Team identified control techniques associated with each of these control objectives. Control techniques are safeguards which managers routinely perform to ensure that waste, fraud, abuse, and inefficiency are eliminated. This was accomplished by interviewing various staff, reviewing written policies and procedures (such as the FSD Flash Code), and referring to specific management actions identified in the narrative and flow charts. (See Appendix H.)

Testing of Control Techniques

The ICR Team formally determined if each control technique was being used and achieving its objective, by means of structured testing exercises. (See Appendix I.) Questionnaires were prepared and distributed by the ICR Team. The tests included the controls which had previously been tested in the OIG audit as well as other controls selected by the ICR Team. The tests were conducted at the Headquarters in Silver Spring, MD, and at the three Branches located in NMFS Regional Offices (NWR, NER, and SER), depending on the location of the source file (i.e. the normal case file, read file, computer file, or other record) being tested. The person conducting the test signed the questionnaire, and was always someone other than the person who had originally prepared that case file.

The ICR Team decided to only examine loan servicing activities occurring after 10/31/91, because they represent how loan servicing is done today. (The OIG audit employed a sample drawn from loans put on the books more than a decade ago, which were administered differently). The sample was designed to be representative of the portfolio, while minimizing the need to pull and review individual loan files. From 10/31/91 to 5/23/93, 163 loans were serviced which included 95 refinancings, 2 assumptions, 4 redemptions (demands paid), 13 deferrals, and 49 advances. A random sample of 56 loans was taken which included 30 refinancings, 2 assumptions, 4 redemptions, 5 deferrals, and 15 advances. This sample is 34% of the loans with servicing activity, 31.6% of all refinancings, 100% of all redemptions, 100% of all assumptions, and 30.6 % of all advances during the 19 month period selected for review. The sample is also 15% of the entire active portfolio of 372 cases on 5/23/93.

Enough tests were performed to be reasonably confident that the findings were accurate, and corresponding with the importance of the technique. The results of each test were then recorded and analyzed.

IV. FINDINGS AND CONCLUSIONS

Evaluation of Internal Controls

The ICR Team examined the results of each test to determine if the control techniques were meeting the associated control objectives, and prepared findings and conclusions. (See Appendix J.) The AU Manager determined if the control system complied with the six specific standards established by the General Accounting Office, which are:

1. Documentation

    Completion of this ICR will meet some of the requirements for documentation of this event cycle. Risks, control objectives, control techniques, and work-flow procedures are now identified and in writing. This reinforces the already extensive documentation of controls contained in the Program's "FSD Flash Code" system and the DOC Handbook.

2. Recording of Transactions and Events

    In all cases there were records that Hull and P & I insurance were in place and were adequate to protect the Government's interests.

    In nearly all cases new terms and conditions included in the Approval in Principle (AIP) letter were recorded in the mortgage. In a few cases involving payment deferrals, however, this was not done. Although no problems resulted, there is a potential for difficulty in foreclosure and arrest of the vessels involved if a default occurs. These mortgages should be amended and the requirement to amend the mortgage should be re-emphasized.

A record of the Coast Guard recordation of mortgage amendments was included in nearly all cases. In a small number of cases mortgage amendments had been sent to the Coast Guard for recordation but had not been returned to the Branch. This could cause difficulty in foreclosure and arrest of the vessels involved in the event of a default. There should be follow-up with the Coast Guard to determine the status of these mortgages.

The ICR Team disagrees with the OIG that loan files do not contain sufficient records that the credit circumstances of loans were considered prior to each servicing action. In all cases reviewed there were sufficient records in the loan file.

In all cases the database was up-dated for each insurance action or event; however, in a few cases servicing actions weren't entered. The database should be kept current.

In a majority of the files reviewed, the ICR Team disagrees with the OIG that required annual financial statements had not been received from borrowers and reviewed. While staffing constraints have somewhat restricted follow-up on this requirement, the financial circumstances of the small number of loans not complying with the requirement were well known by the Loan Officers involved.

The ICR Team agrees with the OIG that in a majority of the files reviewed there is no record that the vessels or facilities were inspected or appraised every 3 years. However, since the Program requires maintenance of insurance coverage on collateral, and insurance companies inspect and appraise on an on-going basis, this requirement is constructively met.

In nearly all cases reviewed there was an indication that Loan Officers had maintained sufficient contact with the borrower to assess the on-going status of the loan. In the rare instances when this was not evident, the loan was so strong from a credit perspective that it was not needed.

The ICR Team agrees with the OIG that in almost all cases annual reports from private credit reporting agencies were not obtained. The ICR team notes that credit reports are required for every new loan. However, the ICR Team agrees with the Program personnel that these reports contain little useful information concerning the small fishing businesses typically involved in FOG loans. Imposition of the reporting requirement would be prohibitably expensive considering the cost of the credit reports and the number of guarantors for each Program guaranteed loan. Because the Program is in all instances the major creditor, the Program's knowledge of the borrower's activities is far more current than the credit reports. The Loan Officer's contact with the lender, knowledge of the borrower, and the maintenance of insurance are much better indicators of a borrower's status.

The ICR Team disagrees with the OIG that in the majority of cases there is no evidence that the borrower's financial statements had been analyzed. On the contrary, in nearly all cases there was evidence in the loan file that the borrower's financial statements had been sufficiently reviewed to determine the on-going status of the loan.

In nearly all cases of refinancing a shorter term or a lower rate was achieved. This strengthens the credit and is to the Government's advantage. The 2 cases where this wasn't achieved were loan work outs and were an appropriate response to a servicing problem. Preserving a credit through a short-term surmountable problem is also in the Government's interest. The circumstances of each loan must be considered to determine if refinancing is appropriate, rather than restricting refinancing to achieving lower rates or shorter terms.

In nearly all cases guarantee fees were recalculated and prorated upon refinancing. In the few cases where that didn't occur the fees were subsequently recalculated. No loss to the Government occurred.

The ICR Team agrees with the OIG that in a majority of refinancings the vessel was not inspected or appraised every 3 years. However, all new loan originations included inspections and appraisals. Refinancings are nearly always done to achieve a lower rate or shorter term which is clearly in the Government's interest. In the few cases where inspections or appraisals were conducted it is apparent that the Loan Officer had other concerns about the loan which precipitated this action. No problems have resulted from this approach.

The ICR Team disagrees with the OIG that applicants' income and expense projections were not reviewed prior to the financing or refinancing. In all cases of origination they were reviewed. In refinancings the Loan Officer knew the borrower's financial condition and achieved a lower rate or shorter term or attempted a loan work-out based on intimate knowledge of the loan.

The ICR Team disagrees with the OIG that applicants' fishing experience/ability were not reviewed prior to the financing or refinancing. In all cases of loan origination they were reviewed. In refinancings the Loan Officer knew the borrower's fishing operation, and the refinancing achieved a lower rate or shorter term or attempted a loan work-out based on intimate knowledge of the loan.

3. Execution of Transactions and Events

In all cases disbursement requests were accompanied by the original invoice or demand.

In all cases but one demands were paid within the statute's required 30 day period. In that case the investor agreed to the Regional Office's request to delay the scheduled payment while the Branch attempted to sell the vessel. The effort to sell the vessel failed and the demand was paid. This verbal agreement was not reduced to writing as it should have been.

In all cases disbursements were properly cleared and approved in accordance with established delegations of authority and filed in the loan file.

In all cases a GCF legal opinion was obtained; however, in 2 cases the opinion was verbal. It should have been recorded in the loan file in writing.

4. Separation of Duties

Key duties were separated among individuals with appropriate checks and balances. In all cases disbursement requests and Approval in Principle letters were reviewed and signed off on by representatives of the credit staff and/or representatives of the legal staff or budget staff.

5. Supervision

Delegations of authority were in writing and were carefully followed. The chain of command was clearly defined and supervision at all levels was continuous. Performance was monitored in accordance with established performance plans and corrective actions were taken when appropriate.

6. Access to and Accountability for Resources

Collateral files were complete and adequately secured in fire-proof, crush-proof cabinets in a storage room equipped with a security-coded lock. Access was limited to personnel who were given the lock code. Access to loan files was restricted by locking file cabinets. Access to computer files was adequately protected by passwords.

The ICR Team also determined if the Program complied with the controls contained in the DOC Handbook. The findings and recommendations are contained in Appendix L.

In conclusion, the ICR Team has reasonable assurance that when the following recommendations are implemented, controls will be in place and operating effectively.

V. RECOMMENDATIONS

The ICR Team made 14 specific recommendations to improve the internal controls associated with the 7 control objectives. Additionally, it made one general recommendation which covers all loan servicing activity. The Responsible Official and Completion Date are indicated for each recommendation. (See Appendix J.)

1. Government's risk of catastrophic loss due to uninsured

collateral is minimized.

- No recommendations.

2. Government does not accept unnecessary financial risk.

- Issue a "FSD Flash" re-emphasizing the existing requirement for all Branches to record in an amendment to the preferred ship mortgage any and all new terms and conditions included in the AIP letter or future amendments to the AIP letter.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 9/30/93

- Issue a "FSD Flash" re-emphasizing the existing requirement for all Branches to secure Coast Guard recordation of mortgage amendments.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 9/30/93

- Establish a Branch Office "watch list" to monitor the status of documents sent to the Coast Guard for recordation in all cases save loan originations where it's always done as part of the closing.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 9/30/93

3. Disbursements are accurate and timely.

- Provide written instructions to Central Office Loan Officers to document in the loan file instances where the 30 day limit was exceeded for loan demands and the reasons for that occurrence.
RESPONSIBLE OFFICIAL: Program Leader
COMPLETION DATE: 9/30/93

4. Servicing actions conform with delegated authorities, regulations, funding allocations, applicable state and Federal laws, and statutory authorities.

- Re-emphasize in written instructions to Central Office Loan Officers the existing requirement to include written legal opinions or "For the Record" documentation of verbal opinions in the loan file.

RESPONSIBLE OFFICIAL: Program Leader
COMPLETION DATE: 9/30/93

5. Potential problem loans are identified and serviced before they default.

• Re-emphasize in written instructions the existing requirement for the Branches to enter all servicing actions in the database.
RESPONSIBLE: Division Chief
COMPLETION DATE: 9/30/93

• Re-emphasize in writing the existing requirement for Branches to obtain and analyze the required financial statements or document "For the Record" in the loan file the reasons for non-receipt of the required financial statements. Include guidance to the Branches to use their own discretion regarding the documentation of their analysis of the financial statements they receive.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 12/31/93

• Request a revision of Program regulations that vessels and facilities be inspected and appraised every 3 years. Provide written guidance to the Branches to use their own discretion regarding the inspection and appraisal of collateral for specific loans.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 12/31/93

• Request by memo that DOC confirm that the requirement for annual credit reports in the DOC "Credit and Debt Management Handbook" does not apply.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 9/30/93

• Provide written instructions to the Branches to include in the loan file the justification for refinancing for purposes other than simply reducing the interest rate.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 12/31/93

• Re-emphasize in writing the existing requirement for Branches to include in the loan file documentation of the

recalculation and proration of guarantee fees for refinancings.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 12/31/93

7. Government doesn't suffer loss due to inattention to OIG identified loan origination deficiencies.

- Re-emphasize in writing to the Branches the existing requirement that an analysis of the borrower's financial condition and income and expense projections were conducted prior to refinancing (for any purpose other than reducing the interest rate) or origination and included in the loan file.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 12/31/93

Overall Recommendation:

- Re-emphasize in writing to the Branches the requirement for immediate implementation of the FOG Program Portfolio Database System as described in FOG Flash No. 380 issued December 22, 1989.
RESPONSIBLE OFFICIAL: Division Chief
COMPLETION DATE: 12/31/93

For convenient reference, a complete description of the results of this ICR (Risks, Objectives, Controls, Tests, Findings & Conclusions, Recommendations) was prepared. (See Appendix K.)